Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1979

No. 79-66

PETER E. AARON,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BRIEF *AMICUS CURIAE*

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MOTION OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves, pursuant to Rule 42(3) of the Rules of this Court, for leave to file the attached brief *amicus curiae* in order to present its views as to the standards properly governing the issuance of an injunction against violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) ("§ 10(b)"), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979) ("Rule 10b-5"). The Institute submits that the Court of Appeals for the Second Circuit erred in its formulation of these standards and contends

that the judgment of that Court should be reversed and the cause remanded for further proceedings.[1]

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 150,000 members. Among its purposes are the promotion and maintenance of high professional standards of practice, and, in pursuit of those purposes, the Institute has come to be accepted as the authoritative source of standards and procedures in its field.

Accountants engaged in professional activities for regulated issuers are, of course, subject to SEC enforcement of § 10(b) and Rule 10b-5. The consequences to such professionals resulting from the issuance of injunctions against them at the instance of the SEC under the rubric of § 10(b) or Rule 10b-5 can be very serious indeed. The Institute accordingly has an important interest in the standards of culpability which must be established by the SEC in order to bring and sustain an injunction action under § 10(b) and Rule 10b-5 and the circumstances under which an injunction can issue for violations of these provisions. In related matters, the Institute was invited to and did testify before the United States Senate concerning the scope of the 1934 Act (*Hearings on S. Res. 84* (72d Cong.) *and S. Res. 56 and S. Res. 97 Before the Committee on Banking and Currency of the United States Senate,* 73d Cong., 1st Sess., pt. 15 at 7207-10 (1934))and was granted leave by this Court to file a brief *amicus curiae* in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976).

The Court of Appeals in this case held that *scienter* is not an essential element of a § 10(b) and Rule 10b-5 injunction action and that proof of negligence will in such actions suffice to establish a violation of that statute and rule. That broad holding appears to be contrary to the rationale of this Court's holding in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), and has serious implications for professionals who service regulated persons.

1. Petitioner has consented to the filing of this brief; respondent's consent has been requested but no response has yet been received.

The case as presented involves as defendants only persons who are directly involved in the securities business. The Court of Appeals simply had no occasion to consider the ramifications for professionals whose relationship to the securities business is ancillary, including accountants, of its view that negligence alone will suffice to warrant injunctive relief under § 10(b). The application of the holding below may, in many cases, result in subjecting accountants, who have been found to have violated § 10(b) on the basis of negligent conduct, and against whom injunctions have issued, to harsh and unwarranted consequences including severe and irreparable damage to their reputations and destruction of their ability to practice their profession. For these reasons, this case transcends the interests of the parties litigant and is of profound significance to the accounting profession.

The Institute will confine its brief *amicus curiae* to the following issue of major importance to the accounting profession as a whole:[2]

> May the SEC obtain an injunction pursuant to § 21 (d) of the Securities Exchange Act of 1934, 15 U.S.C.

2. The Petition also presents the issue of whether the SEC may obtain an injunction pursuant to § 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b) (1976), restraining acts or practices in violation of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), in the absence of pleading and proof of defendant's *scienter.* The Institute has not formulated and does not express any position with respect to that issue.

§ 78u(d) (1976), restraining acts or practices in violation of § 10(b) of the 1934 Act and Rule 10b-5 in the absence of pleading and proof of the defendant's *scienter*?

Respectfully submitted,

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Preliminary Statement

The American Institute of Certified Public Accountants (the "Institute") submits this brief *amicus curiae* in order to present its views as to the standards properly governing the issuance of an injunction against violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) ("§ 10(b)"), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979) ("Rule 10b-5"). The Institute submits that the Court of Appeals for the Second Circuit erred in its formulation of these standards and contends that the judgment of that Court should be reversed and the cause remanded for further proceedings.

Opinions Below

The opinion of the Court of Appeals (Anderson, Feinberg and Timbers, C.J.J.) affirming the decision of the District Court, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 (2d Cir. 1979), is not yet officially reported and is printed in the Appendix to the Petition for Certiorari. The Opinion of the District Court which granted the Securities and Exchange Commission ("SEC") a permanent injunction against petitioner Peter E. Aaron is reported at [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,043 (S.D.N.Y. 1977).

Question Presented

The Institute as *amicus curiae* addresses the following question presented in the Petition for Certiorari:[1]

> May the SEC obtain an injunction pursuant to § 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d) (1976) ("§ 21(d)"), restraining acts or practices in violation of § 10(b) and of Rule 10b-5 in the absence of pleading and proving the defendant's *scienter*?

Additional Statute Involved

In addition to § 10(b) and Rule 10b-5 to which reference has been made in the Petition for Certiorari, there is involved § 21(d) of the Securities Exchange Act of 1934 which reads in relevant part as follows:

> Wherever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, . . . it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. . . .

1. The Petition also presents the issue of whether the SEC may obtain an injunction pursuant to § 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b) (1976), restraining acts or practices in violation of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), in the absence of pleading and proof of defendant's *scienter*. The Institute has not formulated and does not express any position with respect to that issue.

Interest of the Institute as *Amicus Curiae*

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 150,000 members. Among its purposes are the promotion and maintenance of high professional standards of practice and, in pursuit of those purposes, the Institute has come to be accepted as the authoritative source of standards and procedures in its field.

Accountants engaged in professional activities on behalf of regulated persons are, of course, subject to SEC enforcement of § 10(b) and Rule 10b-5. The consequences to such professionals which may result from the issuance of injunctions against them at the instance of the SEC under the rubric of § 10(b) or Rule 10b-5 can be very serious indeed. The Institute accordingly has an obvious interest in the standards of culpability which must be established by the SEC in order to bring and sustain an injunction action under § 10(b) and Rule 10b-5 and the circumstances under which an injunction can issue for violations of these provisions. In related matters, the Institute was invited to and did testify before the United States Senate concerning

the scope of the 1934 Act (*Hearings on S. Res. 84* (72d Cong.) *and S. Res. 56 and S. Res. 97 Before the Committee on Banking and Currency of the United States Senate,* 73d Cong., 1st Sess., pt. 15 at 7207-10 (1934)) and was granted leave by this Court to file a brief *amicus curiae* in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976).

The Court of Appeals held that *scienter* is not an essential element of a § 10(b) and Rule 10b-5 injunction action and that proof of negligence will in such actions suffice to establish a violation of that statute and rule. (Appendix to Petition for Writ of Certiorari, pp. 13a-14a.) That broad holding appears to be contrary to the rationale of this Court's holding in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976). The case as presented here involves a defendant who is directly involved in the securities business. Nevertheless, the ramifications of the Court of Appeals' view of the necessary showing for injunctive relief extend to professionals whose relationship to the securities business is ancillary, including, most obviously, accountants. Thus, the application of the holding below may, in many cases, result in subjecting accountants, who have been found, on the basis of negligent conduct, to have violated § 10(b) and against whom injunctions have issued, to harsh and unwarranted consequences including severe and irreparable damage to their reputations and destruction of their ability to practice their profession. For these reasons, this case transcends the interests of the parties litigant and is of profound significance to the accounting profession.

Statement

Peter E. Aaron ("Aaron") was employed by E.L. Aaron & Co. ("Aaron & Co."), a broker-dealer registered with the SEC. In November 1974, Aaron & Co. opened a branch in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, also an Aaron & Co. registered representative, was assigned to assist Schreiber.

From November 1974 through September 1975, Aaron & Co. made a market in the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). In promoting LAM's stock, Schreiber and Jacobson made false and misleading statements to prospective purchasers. When Schreiber and Jacobson continued making such statements despite warnings from LAM officers that such statements were false, LAM's attorney contacted Aaron and informed him that his sales representatives were making false and misleading statements. Aaron was in charge of the due diligence files for securities in which Aaron & Co. made markets. As a result, he had independent reason to know that the information about LAM being disseminated by Schreiber and Jacobson was untrue. Although Aaron notified Jacobson of the LAM attorney's complaint, he did nothing to stop the false and misleading statements being made by Schreiber and Jacobson.

The SEC commenced an enforcement action in the United States District Court for the Southern District of New York against Aaron and seven other defendants on February 26, 1976. It sought preliminary and final injunctive relief, pursuant to § 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), and § 21(d) of the 1934 Act. The complaint charged, among

other things, that Aaron and the other defendants had violated, and aided and abetted violations of, § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), § 10(b) of the 1934 Act, and Rule 10b-5.[2]

With respect to the SEC's claim asserted against Aaron under § 10(b) and Rule 10b-5, the District Court stated:

> While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, . . . the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,043 at 91,685.

The Court of Appeals concluded that it was unnecessary to consider whether Aaron's conduct would support a finding of *scienter,*

> since we hold that the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under §§ 10(b) and 21-(d) of the 1934 Act. Consistent with the pre-*Hochfelder* decisions of this Court, we continue to hold that allegations and proof of negligence alone will suffice. . . . [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,128.

The SEC urged that Petitioner be granted a writ of Certiorari and on October 15, 1979, this Court granted Certiorari. 48 U.S.L.W. 3258 (No. 79-66).

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2. The complaint also charged Aaron and three other defendants with violating, and aiding and abetting violations of, the registration provisions of §§ 5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§ 77e(a) and 77e(c) (1976). The District Court held that Aaron had violated § 5 and the Court of Appeals affirmed this aspect of the District Court's opinion. The Petition for Certiorari does not appear to question the opinion of the Court of Appeals insofar as it held that there was a § 5 violation. For this reason, the facts relating to the § 5 claim are not summarized above.

ARGUMENT

The SEC is not entitled under § 21(d) of the 1934 Act to an injunction restraining acts or practices in violation of § 10(b) and Rule 10b-5 in the absence of a showing of *scienter*.

Summary

In *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), this Court specifically left open "the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5." *Id.* at 194 n.12. The Institute submits that the Court should now conclude that *scienter* is a necessary element in such an injunction action.

That conclusion, the Institute submits, follows from the analysis required by the *Hochfelder* decision itself. The operative statutory language of § 10(b) points as unambiguously to the proscription of wilful conduct when injunctive relief is sought by the SEC as this Court found it did when damage relief was sought by a private plaintiff. Section 21(d), under which the SEC brings injunction actions for violations of § 10(b) and Rule 10b-5, in no way lessens the degree of culpability which the SEC must prove. Under § 21(d), only conduct which violates § 10(b) may be enjoined; only such conduct as exhibits *scienter* violates § 10(b). The statutory history of the pertinent provisions fully supports the same conclusion. The requirement of *scienter* for injunctive relief is not inconsistent with the statutory structure considered in *Hochfelder* and, indeed, a contrary conclusion would produce anomalous statutory consequences. Finally, the Court below was incorrect both in relying at all on policy considerations to support its adherence to pre-*Hochfelder* doctrine and in its analysis of the policy considerations once it undertook to consider them.

All of these considerations—statutory language, history, structure and policy—must be viewed in this case in the light of *Hochfelder*. The Institute submits that the Court below misapprehended the significance of *Hochfelder* on this issue and that an appropriate consideration of these elements leads irresistibly to the conclusion that *scienter* is required in SEC injunction actions.

A. The relevant statutory language mandates that *scienter* be established in all actions brought under § 10(b)

1. *The Language of § 10(b)*

This Court has become increasingly adamant in its insistence that questions of statutory interpretation must always begin—and, where appropriate, end—with an understanding of the adequately clear statutory language. As this Court said in *Hochfelder*:

> In view of the language of § 10(b), which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its context, *United States* v. *Oregon*, 336 U.S. 643, 648 (1961); *Packard Motor Car Co.* v. *NLRB*, 330 U.S. 485, 492 (1947), further inquiry may be unnecessary. 425 U.S. at 201.

In *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, —— U.S. ——, 48 U.S.L.W. 4001, 4002 (Nov. 13, 1979), the Court reiterated its view that the language of the statute itself is the touchstone of statutory construction. In *Touche Ross & Co.* v. *Redington*, 99 S. Ct. 2479, 2485 (June 18, 1979), the Court emphasized that other considerations play no part in statutory interpretation when the legislative text itself is clear. In short, this Court's requirement that

statutory analysis focus upon the plain meaning of statutory language is now well settled. *E.g., Cannon* v. *University of Chicago*, 99 S. Ct. 1946, 1953 (May 14, 1979); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 24 (1977); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J. concurring).

The Court below paid only lip service to this requirement, deciding that the language of the section alone was "not determinative" of the issue. [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,130. The Court divined from a history of differing judicial interpretations of the language of § 10(b) that the statutory language was unclear as to whether or not *scienter* was a component of a violation of its terms. Without further analysis or discussion, the Court left the question of statutory exegesis and passed on to other methods of statutory interpretation.

This casual treatment of the statutory text accords with neither the method nor the result required by *Hochfelder*. For in *Hochfelder* this Court authoritatively interpreted the language of § 10(b) and left no residual doubt as to the conduct embraced by its prohibitions. The Court there concluded that the statutory "words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." 425 U.S. at 197. The Court found that the use of such words made "unmistakable a congressional intent to proscribe a type of conduct quite different from negligence". *Id.* at 199. The Court specifically found that the language of § 10(b) "clearly connotes intentional misconduct". *Id.* at 201.

Such unclarity as may have subsisted in the judicial interpretation of the statutory language before *Hochfelder*

did not survive the definitive interpretation of that language there announced. What emerges from the *Hochfelder* interpretation is a clear understanding that § 10(b) proscribes conduct involving *scienter* and does not proscribe conduct which does not involve *scienter*. *Scienter* is, in short, definitively established to be an indispensable ingredient of those acts or practices violative of the section.

Of course, as the Court of Appeals below recognized, the statutory language is the same whether the relief sought for its violation be an award of damages or an injunction and whether the plaintiff is a private party or the SEC. [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,130. In *Hochfelder,* the SEC itself argued, and Justices Blackmun and Brennan noted in dissent, that the question of whether negligent conduct constitutes a violation of § 10(b) should not depend upon the plaintiff's identity. 425 U.S. at 217 (Blackmun, J. dissenting); *see* Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder,* 51 N.Y.U.L. Rev. 769, 778 & n.66 (1976).

There appears, then, in the text of the operative prohibitory section nothing to suggest that an injunction can be obtained against conduct which does not involve provable *scienter*.

2. *The Language of § 21(d)*

The Court in *Hochfelder,* of course, was considering the content and meaning of § 10(b) for the purpose of determining the elements of a *prima facie* case to enforce the implied cause of action for damages previously held by the Court to be available. Here, however, the SEC does not depend upon an implied cause of action; the cause of action

for injunctive relief at the instance of the Commission is explicitly created by § 21(d) of the 1934 Act and its elements are prescribed by the language of that section.

The text of § 21(d) is unambiguous. It requires an affirmative showing that a person "is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter . . . ." The language plainly incorporates by reference the proscriptive content of other provisions of the 1934 Act—in this case of § 10(b). As this Court has conclusively determined that § 10(b) proscribes only conduct committed with the requisite *scienter,* it is only such conduct for which the SEC can seek relief under § 21(d). Nothing in the statutory language of § 21(d) authorizing injunctive relief intimates that by its own terms any of the elements of a violation of other provisions of the chapter are relaxed or that the prohibitory scope of those other provisions is in anyway expanded.

The net result of an examination of the statutory language, in the light of the *Hochfelder* interpretation of § 10(b), then, is unmistakable: Under § 21(d) only that conduct which violates § 10(b) may be enjoined when the latter section is invoked as the basis for seeking injunctive relief; and only such conduct as exhibits the requisite *scienter* is prohibited by and constitutes a violation of § 10(b). The statutory language leaves little room for considerations of history, structure or policy, given the force of its plain meaning. An examination of those further considerations, however, reinforces the view that the statutory language indeed means what it says.

B. The relevant statutory history indicates that *scienter* must be shown in SEC injunctive actions for violations of § 10(b)

1. *The Legislative History of § 10(b)*

After examining the language of § 10(b) and concluding that it unmistakably proscribed intentional and wilful misconduct, the Court next turned to the legislative history of the 1934 Act and found that "relevant portions of that history support our conclusion that § 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone." 425 U.S. at 201. A consideration of that history in the light of the issue presented here leads to an identical conclusion.

It is unnecessary to reiterate here the analysis of the history of § 10(b) set out by the Court in *Hochfelder,* 425 U.S. at 201-06, or to examine again the materials upon which that review depended. Just as with the language of § 10(b), the legislative history of that section, and of the 1934 Act as a whole, is the same whether it is interpreted in connection with an action for damages or one by the SEC for an injunction. All the elements of legislative history marshalled by the Court to establish the necessity of showing *scienter* for damage relief equally establish the necessity for the same showing when injunctive relief is sought.

Indeed, that legislative history is even more pertinent to the issue presented in this case. In *Hochfelder,* the Court mined the legislative history to discover clues to the putative intent of the Congress about the elements of a cause of action which, in fact, was not implied by the courts until 12 years after the 1934 Act was passed. *See Kardon*

v. *National Gypsum Co.,* 65 F. Supp. 512, 513-14 (E.D. Pa. 1946). The exercise which occupied the Court in *Hochfelder* was to define from those historical materials what the intent of the Congress would have been had it focused on the elements of a private cause of action for damages during the consideration of the 1934 Act. The Court concluded from the evidence of what the Congress and the draftsmen thought about issues which were before them that they plainly intended *scienter* to be an element of the conduct proscribed by § 10(b) and would have articulated such a view about damage suits if they had focused on that question.

The whole history of the section is even more persuasive in this case precisely because injunctive relief at the instance of the SEC was one of the issues before the Congress in explicit terms when the 1934 Act was considered. *See SEC* v. *Blatt,* 583 F.2d 1325, 1333 n.21 (5th Cir. 1978). The legislative materials indicating an intent to require *scienter* as an element of the conduct forbidden by § 10(b) constitute the very history that developed in the course of considering "clear statutory provisions reinforced by penal and civil sanctions" of which civil sanctions the injunction was explicitly one. S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934). *See Hochfelder,* 425 U.S. at 204-05. Since this history in fact reflects the deliberative process of draftsmen and legislators who were directly concerned with injunctive actions under § 10(b), the conclusion that *scienter* was regarded as an indispensable ingredient of the proscribed conduct for that purpose is even more certain than that it was intended to be an element of private damage actions. *See* Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder,* 51 N.Y.U.L. Rev. 769, 776 (1976).

2. *The Legislative History of § 21(d)*

The Court of Appeals concluded that the legislative history of § 21(d) buttressed its holding that *scienter* was not intended to be required in SEC injunction actions. The Court relied largely on what it termed the "legislative discussion" of § 21(d) occurring upon the enactment of the Securities Acts Amendments of 1975. Seizing in particular upon a statement in a Senate Report indicating that *scienter* was not an element "required to be demonstrated in a Commission injunctive action", S. Rep. No. 75, 94th Cong., 1st Sess. 76 (1975), *citing SEC* v. *Everest Management Corp.*, 475 F.2d 1236, 1240 (2d Cir. 1972), the Court concluded: "It would be difficult to find a clearer indication, at the time of the enactment of § 21(d), that Congress intended to exempt SEC injunction actions from the scienter requirement applicable to private actions." [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,131.

This "legislative discussion" provides little, if any, support for the Court's holding. Statements in the Senate Report simply do not fairly qualify as legislative history of § 21(d), inasmuch as § 21(d) was not enacted, nor was its substantive content altered in any way, by Congress as part of the amendments of 1975. The amendments of 1975 merely renumbered former § 21(e) as present § 21(d). Legislative intent must be gleaned from events contemporaneous with a statute's enactment rather than from a gloss imposed by subsequent legislative constructions. *See Transamerica Mortgage Advisors, Inc.* v. *Lewis*, —— U.S. —— , 48 U.S.L.W. 4001, 4004 n.13 (Nov. 13, 1979); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 199-200 (1963); *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 348-49 (1963). This Court has not infrequently cautioned that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States* v. *Price*, 361 U.S. 304, 313 (1960).

Moreover, the observations contained in the Senate Report that *scienter* was not required in an SEC injunction action should be accorded little weight for another reason. Such conclusion was undoubtedly based upon an analysis of existing case law which indeed provided some support for the conclusion. *Compare SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969) *with SEC* v. *Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). However, such case law pre-dated this Court's construction of § 10(b) in *Hochfelder* and therefore, unless consistent with *Hochfelder*, is of no further vitality.

Apart from the "legislative discussion" of § 21(d) in the Senate Report pertaining to the Securities Acts Amendments of 1975, the Court of Appeals relied upon additional legislative history contemporaneous with the enactment of the 1933 and 1934 Acts. However, the legislative history relied upon by the Court, *see* [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,130 n.14, pertains not to the availability of an injunction under § 21(d) of the 1934 Act, but rather, to the standard of culpability requisite for a violation of § 17 of the 1933 Act. The fact that Congress, in enacting the 1933 Act, ultimately rejected a standard of wilful conduct under § 17, as proposed by the Senate draft, S. 875, 73d Cong., 1st Sess. § 13, 77 Cong. Rec. 2982 (1933), and thereafter at the time of the enactment of the 1934 Act similarly rejected a proposed amendment to § 17 to require such a showing of wilfulness,

78 Cong. Rec. 8703 (1934), has no bearing on the standard of culpability necessary for issuance of an injunction under § 21(d) for violation of § 10(b) of the 1934 Act. Moreover, the statement by the Court of Appeals that the same pattern of culpability requirements established by the 1933 Act were incorporated in the 1934 Act finds no support in the provision cited by the Court. Act of June 6, 1934, Pub. L. No. 291, ch. 404, § 210, 48 stat. 881. That section merely transfers the administration of the 1933 Act from the Federal Trade Commission to the Securities and Exchange Commission.

In sum, the Institute submits that this Court's concluding language in *Hochfelder* applies with equal, if not greater, force to injunctive actions brought by the SEC under § 21(d):

> When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct. 425 U.S. at 214 (footnote omitted).

C. To Hold That *Scienter* Is Not Required In Injunctive Actions Would Produce Statutory Incongruity

The Court in *Hochfelder* found additional support for its interpretation of § 10(b) in the tightly interwoven network of statutory provisions in the 1933 and 1934 Acts. It found that permitting an implied cause of action for a violation of § 10(b) to be maintained without a showing of *scienter* would be inconsistent with the procedural safeguards which circumscribed the causes of action expressly created by the

Acts. 425 U.S. at 206-11. The Court below thought that interpreting § 10(b) as not requiring *scienter* in injunctive cases did not do any violence to the scheme which this Court analyzed in *Hochfelder*. While the Court below overlooked one major anomaly that would ensue from such an interpretation, it is at least fair to comment that taking the Court of Appeals' viewpoint at face value, its converse is also true: There is also nothing inconsistent with the statutory scheme in requiring a showing of *scienter* for injunctive relief.

The Court of Appeals, however, again failed to come to grips with the significance of a portion of the *Hochfelder* decision. A correct understanding of the implications of Part II D of *Hochfelder*, 425 U.S. at 212-14, indicates that unless *scienter* is required for SEC injunctive relief a statutory absurdity would result. The passage addresses a contention, submitted by the SEC, that subsections (b) and (c) of Rule 10b-5 were cast in language which, if standing alone, could encompass both intentional and negligent behavior. From this the Commission argued that a cause of action could be made out under these subsections of the Rule in the absence of a showing of *scienter*.

The Court rejected this contention in part on the ground that it was inconsistent with the administrative history of the adoption of the Rule itself. 425 U.S. at 212. The Court, however, went further in an analysis that is instructive on the present issue. The Court specifically held that if Rule 10b-5 attempted to prohibit conduct which was not prohibited by § 10(b), from which the Commission derived the authority to issue the Rule at all, then Rule 10b-5 was, to that extent, invalid. The Court emphasized that "[t]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not

the power to make law." *Id.* at 213. Rather, the Court went on to hold:

> [I]t is "'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'" *Dixon* v. *United States,* 381 U.S. 68, 74 (1965), quoting *Manhattan General Equipment Co.* v. *Commissioner,* 297 U.S. 129, 134 (1936). Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b). For the reasons stated above, we think the Commission's original interpretation of Rule 10b-5 [requiring *scienter*] was compelled by the language and history of § 10(b) and related sections of the Acts. See, *e.g., Gerstle* v. *Gamble-Skogmo, Inc.,* 478 F. 2d 1281, 1299 (CA2 1973); *Lanza* v. *Drexel & Co.,* 479 F. 2d 1277, 1304-1305 (CA2 1973); *SEC* v. *Texas Gulf Sulphur Co.,* 401 F. 2d, at 868 (Friendly, J., concurring); 3 Loss, supra, n. 17, at 1766; 6 *id.,* at 3883-3885. *Id.* at 214.

Thus, the Court held that in enforcement of § 10(b) the Commission does not have the power to promulgate a rule which forbids conduct not involving *scienter.* If, however, § 10(b) should be construed as not requiring *scienter* in injunctive actions, the incongruous result would ensue that the Commission could prohibit by injunctive action that which it has no authority to prohibit under its own rulemaking power. Given the evident respect which the Congress and the courts have accorded to the SEC's authority to make appropriate rules for the administration and enforcement of the securities laws, it would be anomalous to suggest that § 10(b) means less when read as the grant of the Commission's rulemaking power than it means when read as the source of a claim for injunctive relief.

Moreover, the Court in holding that the Commission lacked power to proscribe unintentional or negligent behavior under § 10(b) plainly went beyond construing the elements of a private cause of action for damages. This portion of the *Hochfelder* opinion examines § 10(b) as a rudimentary source of SEC authority. The constraints which the Court found to limit the SEC's rulemaking authority limit *pari passu* its authority to seek injunctive relief derived from the same statutory source.

Thus, whether examined from the standpoint of a literal reading of the plain language of the pertinent statutory texts, or from the legislative history or a consideration of the anomalous consequences of a contrary ruling, the result appears plain. Section 10(b) does not prohibit unintentional conduct and the SEC, drawing on the powers it derives from that section, may not seek to enjoin such conduct.[3]

3. This conclusion is not disturbed by the reading which some lower federal courts have given to *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963), as standing for the proposition that the SEC need not prove *scienter* in order to obtain injunctive relief prohibiting future violations of § 10(b). *See, e.g., SEC* v. *World Radio Mission, Inc.,* 544 F.2d 535, 540 (1st Cir. 1976); *SEC* v. *Manor Nursing Centers, Inc.,* 458 F.2d 1082, 1096 (2d Cir. 1972); *SEC* v. *Pearson,* 426 F.2d 1339, 1343 (10th Cir. 1970). Neither the District Court nor the Court of Appeals below cited *Capital Gains* for this proposition. Accurately read, *Capital Gains* does not support that proposition at all.

In *Capital Gains,* the defendants were engaging in the repeated practice of purchasing shares of a security for their own accounts shortly before recommending the security to their clients and immediately selling their own shares after the ensuing rise in the market price. 375 U.S. at 183. Defendants never disclosed any aspect of these transactions to their clients. *Id.* This Court held that the SEC need not prove fraud and deceit "in their technical sense," including "intent to injure and actual injury to clients" (375 U.S. at 185-86) in order to obtain limited injunctive relief under the Investment Advisers Act of 1940, 15 U.S.C. § § 80b-1 - 80b-21 (1976) (the "1940 Act"). The Court did not hold that negligence—a word it never used—is a sufficient degree of culpability upon which to grant

(footnote continued on following page)

D. To The Extent That Policy Is Pertinent At All, Sound Policy Considerations Favor A *Scienter* Requirement In § 10(b) Injunction Actions

Despite the plain language and legislative history of § 10(b), the Court of Appeals below decided that *scienter* was not a necessary element of § 10(b) and Rule 10b-5 injunction actions, largely relying upon "policy considerations underlying the securities acts", namely, "that the increased effectiveness of government enforcement actions predicated on a showing of negligence alone outweighed the danger of potential harm to those enjoined from violating the securi-

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(footnote continued from previous page)

the SEC injunctive relief under the 1940 Act. It merely held that the SEC need not prove that the investment adviser specifically intended by its actions to injure or do harm to its clients, in order to obtain an injunction, limited in scope, against further violations of § 206 of the 1940 Act ("§ 206"). 375 U.S. at 195.

Capital Gains does not support the proposition that injunctive relief may be granted for violations *of § 10(b)* in the absence of a showing of *scienter* for two additional reasons. First, in *Capital Gains,* the Court construed a statute which was crucially different in its language. Like Rule 10b-5, but unlike § 10(b), § 206 proscribed "any . . . practice . . . which operates as a fraud or deceit". The Supreme Court has since recognized that such language does not necessarily imply a requirement of intent to deceive. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 212 (1976). In contrast to that language, however, this Court in *Hochfelder* specifically decided that the phrase "manipulative or deceptive device" set forth in § 10(b) clearly does impose such a *scienter* requirement. *Id.* at 199-201; *see also, Steadman* v. *SEC,* 603 F.2d 1126, 1131-32 (5th Cir. 1979) (distinguishing the language of § 17(a), which is nearly identical to the operative terms of § 206, from the language of § 10(b)).

Second, the Court in *Capital Gains* relied heavily upon the legislative history of the 1940 Act. *See* 375 U.S. at 186-95. On the basis of that legislative history, the Court concluded that the statute was enacted, in part, to prevent violations of fiduciary duty by investment advisers. *Id.* at 189-92. As we have already developed, *Hochfelder* specifically found that there was no indication in the legislative history of the 1934 Act that § 10(b) was intended to proscribe conduct not involving *scienter.* 425 U.S. at 202, 206.

ties laws."[4] [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,129. The Court's reliance on policy in the face of the clear language and legislative history of § 10(b) was utterly inappropriate as *Hochfelder* itself teaches and as subsequent cases confirm. *Touche Ross & Co.* v. *Redington,* 99 S. Ct. 2479 (June 18, 1979); *Transamerica Mortgage Advisors, Inc.* v. *Lewis,* —— U.S. ——, 48 U.S.L.W. 4001 (Nov. 13, 1979).

In *Hochfelder,* this Court concluded that since the language and history of § 10(b) were "dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of policy, set forth by the parties, that may have influenced the law-makers in their formulation of the statute." 425 U.S. at 214 n.33.

The generalized concerns about the underlying policies of the securities laws which the Court below invoked as a principal ground of interpretation simply will no longer do as a substitute for rigorous statutory analysis. As this Court held earlier this year in *Touche Ross & Co.* v. *Redington,* 99 S. Ct. 2479 (June 18, 1979):

> The invocation of the "remedial purposes" of the 1934 Act is similarly unavailing. Only last Term, we emphasized that generalized references to the "remedial purposes" of the 1934 Act will not justify reading a provision "more broadly than its language and the statutory scheme reasonably permit." *Securities and Exchange Commission* v. *Sloan,* 436 U.S. 103, 116, 98 S. Ct. 1702, 1711, 56 L. Ed. 2d 148 (1978); see *Ernst & Ernst* v. *Hochfelder,* 425 U.S., at 200 . . . . The ultimate question is one of congres-

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4. It should be noted that those same policy considerations of effective enforcement could well lead to the conclusion that a violation can occur without any degree of culpability on defendant's part.

> sional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law. *Id.* at 2490.

The Court below, therefore, should not have used policy considerations as governing criteria for its statutory analysis. Having begun the process of policy consideration, moreover, the Court of Appeals satisfied itself with rote incantations about the necessity for flexible and effective SEC enforcement authority. This approach not only begs the central question, but it also ignores, as explained below, the increasing modern understanding that wide-ranging injunctive power can do unwarranted harm. *See, e.g., SEC* v. *Blatt,* 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC* v. *Commonwealth Chemical Securities, Inc.,* 574 F.2d 90, 99 (2d Cir. 1978).

The Institute urges that sound policy considerations require that *scienter* be shown in injunction actions brought for violations of § 10(b) and Rule 10b-5. Contrary to the view expressed by the Court of Appeals below, effective enforcement of § 10(b) and Rule 10b-5 is neither precluded nor substantially hampered by imposing a requirement that the SEC prove *scienter*. The SEC has not contended and we do not construe the decision of the Court of Appeals as holding that an injunction may issue simply upon the finding of acts of past negligence. Whatever level of culpability the SEC must show to establish a violation of § 10(b) in order to obtain injunctive relief, it must also establish a likelihood that the conduct of the defendant will recur. *E.g., SEC.* v. *Blatt,* 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC* v. *Keller Corp.,* 323 F.2d 397, 402 (7th Cir. 1963); *Cf. United States* v. *W.T. Grant Co.,* 345 U.S. 629, 633 (1953) (likelihood of recurrence a necessary element for injunctive relief under § 11 of the Clayton Act, 15 U.S.C. § 21 (1976)).

Where *scienter* has been established, a likelihood of recurrence may, under certain circumstances, be inferrable without proof that the conduct is actually continuing since the wilfulness may itself imply a propensity toward repetition. *See, e.g., SEC* v. *Management Dynamics, Inc.,* 515 F.2d 801, 807 (2d Cir. 1975). Such an inference has not been thought generally proper from proof of past acts of simple negligence.[5] A likelihood of recurrence might, of course, be established by showing that defendant was persisting in a course of negligent conduct. But in many such cases an inference of *scienter* could be drawn from defendant's persistence in that course of conduct. In such cases, the SEC would not need to premise its case on negligence at all in order to prevent such on-going misbehavior. In sum, effective enforcement of § 10(b) would not be materially impaired by holding that a claim for injunctive relief could be established only by a showing of *scienter.*

In stating that effective enforcement of the securities acts outweighed the danger of potential harm to those enjoined, the Court below relied upon two of its own decisions which minimized the hardship which may result from the issuance of an injunction. *SEC* v. *Spectrum, Ltd.,* 489 F.2d 535, 541 (2d Cir. 1973); *SEC* v. *Texas Gulf Sulphur*

5. It has long been settled that evidence of a prior negligent act is inadmissible to prove that an individual again acted negligently. *Barnes* v. *Norfolk Southern Railway Co.,* 333 F.2d 192, 197 (4th Cir. 1964); *Brownhill* v. *Kivlin,* 317 Mass. 168, 171, 57 N.E.2d 539, 540 (1944); *Levant* v. *Leonard Wasserman Co.,* 445 Pa. 380, 382-83, 284 A.2d 794, 796 (1971). A serious question exists as to whether injunctive relief should ever be issued on the basis of negligent conduct or to restrain negligent conduct. Since negligence is inadvertent and unintended, no legitimate purpose appears to be served by enjoining it. There is also a serious question as to whether a violation of an injunction may be found on the basis of subsequent negligent acts. These questions are alluded to in *SEC* v. *Universal Major Industries Corp.,* 546 F.2d 1044, 1047 n.1 (2d Cir. 1976), *cert. denied sub nom. Homans* v. *SEC,* 434 U.S. 834 (1977).

Co., 401 F.2d 833, 854-55, 868 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969). Contrary to the views expressed in those cases, there has been a recent judicial recognition—according more realistically with actual experience—that the consequences flowing from the issuance of an injunction for violations of § 10(b) can be quite severe. *SEC* v. *Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 99 (2d Cir. 1978).[6]

The effects are particularly detrimental when the injunction is directed against professionals such as accountants. The mere determination that an accountant violated the antifraud sections of the federal securities laws—which under the decision of the Court of Appeals below could well occur upon a finding of a single act of negligence—even in the absence of the issuance of an injunction, could have extremely significant adverse consequences. The publicity which will almost certainly attend the issuance of an injunction or a finding of a federal securities act violation will plainly and often irrevocably affect the reputation of

6. In the area of SEC administrative proceedings, the courts have emphasized the substantial, detrimental effects that ensue to a defendant when an adverse decision is rendered. *E.g., Steadman* v. *SEC*, 603 F.2d 1126, 1138-43 (5th Cir. 1979); *Whitney* v. *SEC*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 96,913 at 95,779 (D.C. Cir. 1979) ("[A] suspension for nine months imposes a serious loss, both as a short-run matter of foregone business, and, perhaps more greviously, as a permanent injury to reputation."); *Collins Securities Corp.* v. *SEC*, 562 F.2d 820, 823-26 (D.C. Cir. 1977). In recognition of these serious repercussions, the courts have required that the SEC support its factual findings of a violation with clear and convincing evidence, rather than a preponderance of the evidence. Application of the higher burden of proof balances the interests of the public and the individual. "Its use in SEC disciplinary proceedings does not forego the 'remedial' aspect of protecting the public." *Id.* at 825-26.

an accountant.[7] This in turn will have a direct and often substantial effect on an accountant's ability to practice his profession. As Judge Friendly recently stated in *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90 (2d Cir. 1978):

> It is fair to say that the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in earlier days. Experience has shown that an injunction, while not always a "drastic remedy" as appellants contend, often is much more than the "mild prophylactic" described by the dissenters in this court in *SEC* v. *Capital Gains Research Bureau, Inc.*, 306 F.2d 606, 624 (2 Cir. 1962), a phrase quoted by the Supreme Court at 375 U.S. 180, 193, 84 S.Ct. 275, 11 L.Ed. 2d 237 (1963). In some cases the collateral consequences of an injunction can be very grave . . . . *Id.* at 99 (footnote omitted).

It should be noted that not requiring the SEC to show *scienter* may involve serious risks for, and may be particularly unfair to, professionals such as accountants. Accountants are regularly called upon to make difficult judgments which require a weighing of complex facts and as to which there is no plain or simple answer. SEC injunction actions often retrospectively challenge such judgments. If *scienter* need not be shown, accountants would

7. Aside from the reputational effects, a wide range of serious collateral consequences flow from an injunctive decree. *See Program of the Committee on Federal Regulation of Securities*, 30 Bus. Law. 1303, 1307-11 (1975) [hereinafter cited as *Federal Regulation of Securities*] (comments of Arthur Mathews). With respect to accountants and other professionls who are named defendants, Rule 2(e) of the SEC's Rules of Practice, 17 C.F.R. § 201.2(e), has a particularly onerous effect. Pursuant to that Rule, the mere entry of an injunctive order—even one entered on consent when the professional does not admit wrongdoing—can provide the basis for precluding a professional from practicing before the Commission. *Federal Regulation of Securities, supra*, at 1310.

face the risk of being found to have violated § 10(b) and being subject to injunctive relief on the basis of hindsight assessments of earlier good faith accounting or auditing judgments, as to which reasonable men may disagree. This is simply too loose a standard upon which to expose accountants to the severe consequences of injunctive relief. In light of the difficulty of predicting the outcome of SEC injunction actions premised on negligence, it can be expected that accountants will often feel compelled, unfairly, to enter into consent judgments.

It is an unfortunate fact that all too frequently persons peripherally involved in a transaction which is the subject of an SEC injunction action, such as accountants or lawyers, who are claimed to have been no more than negligent, will suffer more from the issuance of injunctive relief than the alleged principal wrongdoers, who are alleged to have been guilty of a high degree of *scienter*. Such principal wrongdoers frequently have little to lose from the issuance of an injunction since their vocations do not depend heavily —and certainly not to the same extent as accountants and other professionals—upon the strength of their reputations. On the other hand, professionals who may only be tangentially involved in a challenged transaction and who may be guilty of no more than a failure to exercise proper judgment, may have their entire professional careers jeopardized by the issuance of an injunction.[8] It can also be expected that if a professional is found to have violated the federal antifraud statutes on the basis of negligence, the world will not make the NICE discriminations necessary to differentiate his role and culpability from that of the primary wrongdoers who may have been found guilty of

8. In fact, with respect to injunctions issued against large accounting and law firms, the impact of the injunction may be felt by all of their partners and professional staff, the vast majority of whom had no involvement at all in the matter. *Federal Regulation of Securities, supra* note 7, at 1321 (comments of Victor M. Earle).

egregious fraud. The effect on the accountant in such cases of a determination that he violated § 10(b) will bear no fair relationship to his wrongdoing.

The Court below therefore erred in regarding policy outcomes as determinative of the statutory question, and erred again in its simplistic assessment of the policy considerations it examined. Nothing in a "circumspect" weighing of policy considerations in any way undermines the conclusion dictated by the statutory language, history and structure. *Scienter* is an element of a violation of § 10(b) and there is no sound reason to dispense with it in SEC injunction actions.

CONCLUSION

The opinion of the Court of Appeals for the Second Circuit should be reversed and the cause remanded for further proceedings in light of this Court's expressions on the necessity of pleading and proving *scienter*.

Respectfully submitted,

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